Testimony of

America's Community Bankers

on

Federal Deposit Insurance Reform

before the

Subcommittee on Financial Institutions and Consumer Credit

of the

Financial Services Committee

of the

United States House of Representatives

on

May 16, 2001

David Bochnowski
Chairman and CEO
Peoples Bank, SB
Munster, Indiana

and

Chairman
America's Community Bankers
Washington, DC

Mr. Chairman and Members of the Committee, I am David Bochnowski, Chairman, President and CEO of Peoples Bank in Munster, Indiana. Our headquarters are in northwest Indiana, near the industrial cities of Gary and East Chicago.

I am here today representing America's Community Bankers (ACB)[1] as ACB's chairman. ACB is pleased to have this opportunity to present our views on deposit insurance reform. Our testimony will cover the issue in three parts: 1) the current policy making climate; 2) the most urgent issue; and 3) key elements of ACB's comprehensive recommendations. Our complete recommendations, which we provided to the FDIC in December of last year, are included in "Deposit Insurance Reform for a New Century: A Comprehensive Response to FDIC Reform Options." A copy of that report is attached to my written testimony.

Bankers have varying views on deposit insurance reform, but let me assure this committee that we are engaged in an open and constructive a dialogue. The staffs of our associations have met to begin a more detailed discussion of our respective policy positions. The entire industry has every incentive to cooperate, because the safety and soundness of the deposit insurance system is important to our customers and the nation's economic health.

Current Climate

Congress faces a good policy making climate for deposit insurance reform. The deposit insurance system faces challenges and problems, but they are manageable provided that action is taken promptly on the most urgent matters. As FDIC Chairman Donna Tanoue has said, the time to fix the roof is when the sun is shining. From our point of view, the outlook is partly to mostly sunny – for now. What accounts for this favorable outlook? There are several economic and policy factors which help explain it:

- In 1989 and 1991 Congress significantly strengthened our financial system by requiring bank regulators to take prompt corrective action if an institution falls below specific capital levels.
- In 1995 the FDIC's Bank Insurance Fund (BIF) reached its statutory minimum reserve ratio of 1.25 percent of insured deposits and has remained above it ever since.
- In 1996 Congress enacted the Deposit Insurance Funds Act that required the industry to pay a one-time assessment of $4.5 billion that brought the FDIC's Savings Association Insurance Fund (SAIF) up to its statutory minimum reserve ratio, where it remains well above today.
- The strong economy has helped banks maintain strong capital levels, minimized the FDIC's losses from failures, and allowed the insurance funds to grow significantly through earnings.

---

[1] ACB represents the nation's community banks of all charter types and sizes. ACB members pursue progressive, entrepreneurial and service-oriented strategies in providing financial services to benefit their customers and communities.

- The Gramm/Leach/Bliley Act of 1999 modernized the structure of the nation's financial system and resolved issues that had been sources of contention for decades.

Under Chairman Tanoue's leadership, the FDIC took advantage of this favorable climate to undertake a broad-based look at deposit insurance issues. The FDIC's August 2000 Options Paper provided the industry and other interested parties a thorough framework to use in sorting out their views on the issues. ACB commends Chairman Tanoue for taking this important initiative. Her work will leave a lasting legacy.

The Most Urgent Issue

The most urgent deposit insurance issue that we face today stems not from a weakness in the system, but ironically, from its strength. Both the BIF and SAIF are above their statutorily required 1.25 percent ratio, so the FDIC does not currently charge a premium to healthy institutions. A few companies are taking advantage of that situation by shifting tens of billions from outside the banking system into insured accounts at banks they control. Unfortunately, the magnitude of these deposit shifts dilutes the deposit insurance funds and reduces the designated reserve ratio. The problem is not that the FDIC is holding fewer dollars – BIF and SAIF balances are stable – but that those dollars are being asked to cover a rapidly rising amount of deposits in a few institutions. As FDIC Chairman Tanoue recently said, "other banks can rightly say that they are subsidizing insurance costs for these and other fast-growing banks."[2]

The situation could worsen. Under current law, if a fund falls below the 1.25 percent reserve requirement and the FDIC does not expect it to return within a year, all insured institutions would have to pay a 23 basis point premium (23 cents for every $100 of deposits). For a community bank with $100 million in deposits, that equals $230,000. For my bank the cost would be over $800,000. These premiums likely could come at the worst possible time – when the national economy and some local economies are shifting to a different pace. Whenever they might come, they would divert resources from communities and shift them to Washington.

How much does this free-rider problem amount to? In 2000, Merrill Lynch swept $36.5 billion from its Cash Management Accounts into insured accounts at its two affiliated banks, effectively reducing the BIF reserve ratio by 2.15 basis points. Merrill has swept an additional $11 billion into those banks this year. If all of that is insured, it would have reduced BIF's reserve ratio by another 0.65 basis points.

Another major firm, Solomon Smith Barney (an affiliate of Citigroup), has swept a total of $17 billion into its BIF- and SAIF-insured affiliates this year. Citigroup has a total of 6 separate FDIC-insured charters, making this program especially attractive to large investors seeking the protection of federal deposit insurance.

[2] Speech, May 10, 2001 (p.2)

ACB does not object to a growth in insured deposits. These firms' activities are perfectly permissible under the current law. But they are diluting the funds and reducing the designated reserve ratio. Without this dilution, the reserve ratio could actually have increased, rather than fallen.

Because of these high-growth programs, long-established and stable institutions in every state could be forced to pay premiums. These institutions collectively paid billions into the FDIC in the late 1980s and 1990s. Each year, all FDIC-insured institutions paid approximately 23 basis points – again, $230,000 for each $100 million in deposits – over $800,000 for my bank. And in 1996 SAIF-insured institutions paid an additional 66 basis points – a total of $4.5 billion. My bank's share of that was $1.6 million. Those substantial payments brought the FDIC back to health. Now, these premiums are being used, in effect to cover new deposits at a few rapidly growing institutions.

What can be done about this situation? Fortunately, there is a ready solution to this problem. Reps. Bob Ney and Stephanie Tubbs Jones have introduced the Deposit Insurance Stabilization Act (H.R. 1293). This bill has three key features:

- **Permitting the FDIC to impose a fee on existing institutions for excessive deposit growth so that the required reserve ratio can be maintained.**
  Currently, the FDIC may impose an excessive deposit growth fee on new institutions or new branches. By allowing the FDIC to impose fees on existing institutions, H.R. 1293 would address the current "free-rider" problem.

- **Merging the BIF and the Savings Association Insurance Fund (SAIF).**
  According to the FDIC, merging the BIF and the SAIF would create a more stable, actuarially stronger deposit insurance fund. In addition, if the funds were merged today, the reserve ratio of the combined fund would be a healthy 1.37 percent (the BIF's reserve ratio has fallen to 1.35 percent, while the SAIF's reserve ratio is 1.44 percent).

- **Allowing for flexible recapitalization of the deposit insurance fund.**
  If the reserve ratio of the merged fund falls below the required level of 1.25 percent, the bill would give the FDIC flexibility in recapitalizing the fund over a reasonable period of time. By repealing the automatic assessment of 23 basis points, H.R. 1293 would give the FDIC authority to use a laser beam approach, rather than a sledgehammer, to recapitalize the insurance fund.

ACB believes that Congress should act quickly on this legislation to help ensure the continued strength of the FDIC and prevent the unnecessary diversion of billions of dollars away from community lending to homeowners, consumers, and small businesses. Acting on this bill now would not preclude action on broader deposit insurance reform. In fact, H.R. 1293 is an excellent place to begin the comprehensive reform process. Other issues could be taken up later this year or – if non-controversial – included in H.R. 1293. By stabilizing the system, this bill would provide Congress an excellent starting point as it debates broader deposit insurance reform issues.

Overview of Comprehensive Reform

Like the FDIC, ACB strongly supports comprehensive deposit insurance reform. We were the first major trade association to provide the FDIC with a complete analysis and recommendations on all the issues the agency raised in its August 2000 Options Paper. Our complete recommendations are included in the booklet distributed to the subcommittee along with this statement.

We are pleased that many of the FDIC's recommendations are consistent with our own, though they differ in one key respect. We agree on: merging the Bank Insurance Fund and the Savings Association Insurance Fund; giving the FDIC flexibility to gradually recapitalize the fund in the event of a shortfall; establishing rebates based on past contributions; and indexing coverage levels.

However, unlike the FDIC, ACB does not believe that the highest-rated institutions should be required to pay premiums when there are ample reserves in the fund. Rather, as provided in the Ney/Tubbs Jones bill, ACB recommends that the FDIC have the authority to assess a special premium on the excessive growth by existing institutions (such as has occurred in banks owned by Merrill Lynch), if necessary to maintain an adequate reserve. (The law already gives the FDIC such authority for new institutions and branches.)

Summary of Recommendations

ACB’s ideal scenario for the deposit insurance system includes creation of a single, stronger Deposit Insurance Fund through a merger of BIF and SAIF. The fund would continue to grow through a combination of earnings and risk-based premiums. The highest rated institutions would not be assessed as long as the fund remained above the statutory minimum of 1.25 percent of insured deposits. Once the fund reaches a new ceiling that would be set by Congress (after close consultation with the FDIC), the FDIC would provide risk-based rebates of any excess funds. The FDIC would have the discretion to adjust this ceiling well-defined strict standards and procedures.

If the fund fell below the statutory 1.25 percent reserve ratio, the FDIC should be allowed to spread the recapitalization over a reasonable period. (Current law requires the FDIC to impose a 23 basis point premium to make up a shortfall that it expects will persist for a year.) This would allow the FDIC to balance the goals of replenishing the fund and maintaining a healthy banking system. Furthermore, this would truly allow the FDIC to manage the insurance fund more effectively

To maintain the integrity of the system, institutions that grow at rates significantly above the industry average in a manner that significantly dilutes the fund should pay a special premium on their excess growth. This would not apply to relatively small, *de novo* banks or to institutions that acquire existing insured deposits. It would not discourage regular competitive growth by established institutions or the formation of new competitors. However, it would deal with institutions that dilute the deposit insurance fund's reserve ratio by precipitately moving large amounts of funds under their effective control from uninsured to insured status.

ACB also recommends indexing the coverage levels to help maintain the role of deposit insurance in the nation's financial system. Congress should use as a base the last time it adjusted coverage primarily for inflation, which was done in 1974. At that time, it increased coverage to $40,000. If adjusted for inflation since that time, the current coverage limit would be approximately $135,000, according to the FDIC.

To recognize the increasingly important role that individual retirement savings plays in the economy and in our pension system, ACB recommends that Congress substantially increase the separate deposit insurance coverage for IRA, 401(k), and similar retirement accounts.

Detailed Recommendations

Congress should set a ceiling on the fund

ACB recommends that Congress set a ceiling on the deposit insurance fund's designated reserve ratio (DRR), giving the FDIC the ability to adjust that ceiling using well-defined standards after following full notice and comment procedures.

In deciding the actual ceiling amount, ACB recommends that Congress ask the FDIC to provide it with a firm recommendation on where it should set a statutory ceiling. The agency has already done considerable historical analysis on the level of the funds and income needed to maintain them.[3] Clearly, the agency could adapt that analysis to determine a reasonable ceiling to recommend to Congress.

ACB agrees with former Chairman Helfer's comment:

> I believe it is possible for the FDIC to develop analytical tools that will permit it to identify a ceiling on the funding needs of the deposit insurance system at any particular time -- a DRR that would change as circumstances change….The purpose of establishing a ceiling DRR is so that insurance funds will not grow beyond a size that can be justified on the basis of the needs of the deposit insurance system, thereby withdrawing capital from banks who could have contributed to economic growth by leveraging those funds to meet the economic needs of their communities. Amounts accumulated in the system over and above the DRR ceiling should be rebated to banks to facilitate economic activity, which benefits every one.[4]

---

[3] 60 Fed. Reg. 42680 (Aug. 16, 1995).

[4] The Deposit Insurance System: What Reforms Make Sense?; Ricki Helfer, December 4, 2000; Address to America's Community Bankers, pp. 9-10 (Helfer, Dec. 4, 2000)

Congress should give the FDIC flexibility to adjust the ceiling. However, the agency should have to meet clearly stated standards before adopting a change. The FDIC should be required to find that a higher level is needed to meet a substantial and identifiable risk to the fund or the financial system. In addition, Congress should require the FDIC to follow a full notice and comment process under the Administrative Procedure Act before making any change to the ceiling. Any delay associated with this process should not cause undue concern, since the FDIC would, in all likelihood, be considering changes when the fund was near its ceiling, substantially above the current 1.25 percent minimum.

Excess reserves should be returned to institutions that paid premiums

Reserves in the fund that exceed the ceiling should be returned to insured institutions based on their average assessment base measured over a reasonable period and based on premiums paid in the past. As indicated later in this statement, the FDIC should also consider risk factors when calculating any rebate. Rebatable premiums would include the 1996 SAIF special assessment, but not the high-growth special assessments.

During the 106th Congress, ACB supported legislation introduced by Senators Rick Santorum (R-Penn.) and John Edwards (D-N.C.) and Reps. Frank Lucas (R-Okla.) and Mel Watt (D-N.C.) that would have set a 1.35 percent ceiling and used the excess to pay interest on FICO bonds.[5] Reps. Lucas and Watt have reintroduced that legislation in the current Congress (H.R. 557). Under their approach, once the FICO bonds were repaid, excess funds would be used to pay rebates. The bill would have given the FDIC authority to change the ceiling.

ACB continues to believe that this is a constructive solution to a serious potential problem that could be caused by a substantially overcapitalized insurance fund. However, the broader approach we outline in this testimony could lead to full rebates more promptly than provided in the Lucas/Watt bill. Whatever the mechanism Congress provides, resources not needed for reasonably foreseeable deposit insurance purposes should not remain in Washington.

Broaden Risk-Based Premium Authority

When the fund is above its statutory minimum level the highest rated institutions should continue to be exempt from premiums, but the FDIC should have authority to impose a justifiable risk-based premium on other institutions.[6] <u>ACB supports this additional authority provided the other important reforms we recommend are included in the final package.</u>

---

[5] S. 2293 and H.R. 3278.

[6] Insured institutions rated 1A are not currently charged deposit insurance premiums. These institutions include those with supervisory CAMELS ratings of both 1 and 2. That is the examiner's composite rating of Capital, Assets, Management, Earnings, Liquidity, and Sensitivity to market risk. ACB believes that CAMELS 1 institutions should remain exempt from premiums, but the FDIC should be able to impose risk-based premiums on CAMELS 2 institutions, even if they are rated 1A for deposit insurance purposes.

The FDIC Options Paper states that, "If deposit insurance were priced according to risk, it is likely that every bank…would pay something for deposit insurance."[7] The FDIC's current recommendation paper states that the current "system both underprices risk and does not adequately differentiate among banks according to risk. The FDIC should be allowed to charge risk-based insurance premiums to all institutions. . . ."[8] These statements fail to take into account the fact that most insured institutions paid substantial premiums in the 1990s to capitalize the FDIC funds. Most BIF- and SAIF-insured institutions paid approximately 23-24 basis points annually for several years, and SAIF-insured institutions made an additional one-time, 66 basis point payment in 1996. Since those institutions have never caused insurance losses, ACB believes that they have already made advance payment to compensate the fund for risk that they pose.

ACB supports risk-based pricing as a means to discourage riskier behavior and maintain the integrity of the deposit insurance system. Such risk-based pricing justifiably might be set on a more steeply graduated schedule than is currently the case. However, such a premium should not extend to the highest rated institutions when the fund is above the statutory minimum. Not only have they already paid substantial premiums, they – by definition – impose an extremely slight risk to the fund.

This broadened premium authority should not, however, be granted in isolation. ACB believes that a more reasonable recapitalization procedure, rebate authority, an excess-growth premium, indexed coverage levels, and greater coverage for retirement accounts are essential elements of a balanced plan.

Rebates should be reduced for riskier institutions

Institutions that pose substantial risk to the fund would have their rebates reduced or eliminated. Under the system we favor, the riskiest institutions would get no rebates, while the safest institutions would get higher than average rebates. Those in between could expect average rebates. These differential rebates would provide a similar risk-reduction incentive as the FDIC's proposed universal premium structure. All institutions would know that when the fund approached the ceiling, they could expect to benefit if they operated in a less risky manner.

FDIC should be able to impose an excess-growth premium

As discussed earlier in this testimony, institutions that grow at a rate significantly above the industry average in a manner that dilutes the fund should be required to compensate by paying a special premium on excess growth. This is a key element of the Ney/Tubbs Jones bill. A growth premium would avoid dilution of the fund by making the fund whole with respect to any excess growth, preventing the imposition of unnecessary premium costs on other institutions.

---

[7] FDIC Options Paper, p. 3. (Options Paper)
[8] Keeping the Promise: Recommendations for Deposit Insurance Reform, April 2001 (p. i)

The special growth premium will not apply to smaller institutions for a reasonable period after they are chartered. It would also not apply to growth through merger or acquisition.

Assessing a special premium only on significant growth would allow premium-free growth by an institution that had developed a particularly successful business plan. But, it would address the case of, for example, a diversified financial firm that was simply transferring significant amounts of uninsured funds under its effective control into its insured bank.

ACB believes that the special premium should compensate the fund at the then-current reserve ratio to avoid dilution of the fund. The FDIC should have the flexibility to collect this premium over a reasonable period to avoid imposing an undue shock on the affected institutions. While the premium might be collected over time, it should be booked immediately as a receivable in the fund to maintain its coverage ratio.

Ironically, Congress permits the FDIC to impose special assessments on *de novo* institutions.[9] Congress recognized that these institutions can be expected to grow at rates that exceed the industry average and impose other risks. However, because of their relatively small size, they cannot be expected to dilute a multi-billion dollar deposit insurance fund. The same thing cannot be said about an existing institution – now effectively exempt from premiums – that embarks on a new business plan that could add tens of billions to the insured deposit base. So, while the law correctly recognizes the risk that a *de novo* institution may impose, it forces the FDIC to ignore the risk posed by an existing institution that begins growing at a rate significantly above the industry average.

As indicated above, the special excess growth premium should not apply to institutions that grow by acquiring existing deposits from other insured institutions. By definition, these deposits are already included in the insured deposit base, so shifting them from one institution to another does not dilute the fund.

The FDIC should have more flexible recapitalization authority

As provided in the Ney/Tubb Jones bill, if the fund falls below 1.25 percent designated reserve ratio (DRR), the FDIC should have the authority to spread the recapitalization over a reasonable period. This would be more responsible than the current law that requires the FDIC to impose a 23 basis point annual premium if the fund is expected to remain below 1.25 percent for a year.

ACB strongly supports changing the assessment system to address the case where the fund falls below 1.25 percent. As the FDIC Options Paper notes, the current system "amounts essentially to charging nothing in times of prosperity, and a lot in times of adversity, thereby potentially magnifying swings in the banking cycle."[10] Congress should correct this by giving

[9] 12 U.S.C. 1815(d)(1)(A).
[10] Options Paper, p. 5.

the FDIC authority to spread any recapitalization over a reasonable period. The FDIC should impose these premiums on a risk-based basis.

Coverage levels should be indexed

ACB supports indexing coverage levels to maintain purchasing power. Congress should index coverage levels starting with the 1974 limit of $40,000. That would result in a coverage level of approximately $135,000. So long as the fund is above its statutory minimum of 1.25 percent of insured deposits, this modest increase in coverage should not require any more than a very minimal premium. If unacceptable premium increases are a condition for an immediate increase in coverage, Congress should at least index coverage from the current $100,000 level.

ACB also strongly supports substantially increasing coverage for retirement savings, such as IRA and 401(k) accounts. In either case, we support increases provided they are not accompanied by substantial additional premiums. Most ACB members are skeptical that increases in general deposit insurance coverage levels would significantly increase funding. Former FDIC Chairman Helfer is even more skeptical. Last year, she said, "there is very little evidence that doubling the coverage limits will expand the deposit base of smaller banks. Community bankers that I have talked to think that very little benefit will result from a significant increase in coverage limits."[11]

Even if coverage is increased to $200,000, the average account balance is certain to remain very substantially below that level. Small depositors with say, $1500 in checking and savings accounts are not going to increase their total deposits just because the upper insurance limit is increased. And, competitive factors suggest that substantially increased nominal coverage will not increase the overall deposit base by a large amount. Depositors with large sums may shift insured deposits from one bank to another to consolidate balances or take advantage of higher interest rates. But, one bank's gain may well be another bank's loss. ACB members who responded to our survey estimated only a net gain of 3 percent as a result of increasing insurance coverage to $200,000. Thus, doubling coverage levels is not the same as doubling the FDIC's risk.

Clearly, an adjustment accounting for inflation since 1974 is reasonable but such an increase would not justify a significant premium increase. If a large premium increase is the price for higher coverage, we would prefer to index coverage from the current level. We agree with former FDIC Chairman Helfer who said that, "Whatever the correct number, it is the principle of indexing that is important."[12]

Indexing on a going-forward basis would certainly not justify any premium increase and would have the clear advantage that the FDIC identified in its Options Paper – insulation from political cross currents and maintaining "the same relative importance of deposit insurance in the

[11] Helfer, Dec. 4, 2000, p. 12
[12] ID, p. 14

economy over time…."[13] Indexing using the current level also avoids the debate over what year and level should be the basis for indexing. For better or worse, depository institutions and the economy have adjusted to the current level of coverage. Indexing would maintain that balance rather than seeking to recalibrate it based on a level that may have been appropriate in the past.

To simplify and reduce the cost of implementation, as well as to promote consumer understanding, we recommend that any increases be provided only in $10,000 increments. Some ACB members are especially concerned that frequent small adjustments would be more costly than any benefit they might realize from increased deposit funding.

Retirement accounts should have substantially more coverage

Congress should also provide substantial increases in coverage levels for retirement savings in conjunction with its work on social security or pension reform or as part of deposit insurance reform, provided this can be accomplished without an unacceptable premium increase.

Congress has provided substantial tax incentives to encourage individuals to accumulate retirement savings. These individual savings are often replacing resources that employers previously provided through defined-benefit pension plans. This shift in retirement funding has increased the burden on individuals to manage their own assets. As individuals respond to tax incentives, their retirement assets often exceed the current $100,000 coverage limit by substantial amounts. Since planners generally recommend that individuals shift these savings into more secure and stable investments as they approach retirement, ACB believes that Congress should substantially increase deposit insurance for retirement savings that meet the tax requirements established under the Internal Revenue Code.

Conclusion

Again, ACB appreciates this opportunity to present our views on these important issues. The deposit insurance system is strong today, but could be made even stronger. We hope that Congress will use the work the FDIC and the industry has done to craft legislation that will make the improvements necessary to ensure the continued stability of this key part of the nation's economy.

ACB would like to emphasize these points from our testimony:

- The deposit insurance system has been helped by legislation that Congress enacted since 1989, as well as by a strong economy.
- The system now faces a significant challenge – excessive growth by a few institutions – that Congress should address right away by acting quickly on the Ney/Tubbs Jones bill, H.R. 1293, which merges BIF and SAIF; provides for an excess growth premium; and permits more flexible recapitalization.

[13] Options Paper, p. 44.

- ACB strongly supports comprehensive deposit insurance reform, and Congress should not delay action on H.R. 1293 while it debates broader issues.
- Comprehensive reform should include:
    - a ceiling on the merged fund;
    - risk-based rebates of past premiums;
    - risk-based premium authority for all but the highest-rated institutions;
    - general coverage levels indexed from the 1974/$40,000 level; and
    - substantially increased coverage for retirement accounts.

America's Community Bankers
900 19th Street, NW
Suite 400
Washington, DC 20006

December 13, 2000

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments/OES
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429

Re: Deposit Insurance Options Paper
August 2000

Dear Mr. Feldman:

America's Community Bankers (ACB) is pleased to comment on the issues presented in the FDIC's Deposit Insurance Options Paper.[1] ACB commends the FDIC for reaching beyond a few narrow deposit insurance issues and seeking comment on a wide range of concerns. ACB represents the nation's community banks of all charter types and sizes. ACB members pursue progressive, entrepreneurial and service-oriented strategies in providing financial services to benefit their customers and communities.

Merge BIF and SAIF

We also commend the FDIC for its continued strong advocacy of merging the Bank Insurance Fund and the Savings Association Insurance Fund. Simply stated, a combined fund would be stronger than either one standing alone. If Congress does nothing else regarding deposit insurance issues, it should merge the funds without delay. There is no reason to postpone this reform if broader issues cannot be resolved promptly. This is a particularly good time to merge the funds, since both are substantially above the statutory reserve ratio. The SAIF ratio is actually higher than BIF's, but each would benefit from the geographic and business diversity that the other would bring to a combined fund.

The Reform Process

Many of the options that the FDIC has raised would also require Congressional action, while some – particularly some changes to the risk-based premium system – could be implemented by the FDIC without further legislation. This letter provides ACB's views on the full range of issues raised in the Options Paper – pricing deposit insurance for

[1] Deposit Insurance Options Paper, August 2000 ("FDIC Options Paper").

individual banks, the FDIC structure most appropriate to fund any losses, and coverage levels.

We developed our positions by holding discussions with hundreds of our members in multiple forums, as well as seeking their views via survey. ACB's 32-member Deposit Insurance Team held 5 meetings, 4 by conference call and a final in-person session on December 4, 2000.[2] In addition, ACB's Community Institutions Committee, Mutual Institution Committee, and our Board of Directors examined these matters during our recent national convention. Throughout the year, ACB's officers discussed deposit insurance issues with our members at ACB management conferences, seminars, and state association meetings. We also met with the board of the American League of Financial Institutions, which represents minority thrifts, during their annual meeting to solicit their views.

How a Reformed System Would Work

ACB's ideal scenario for the deposit insurance system includes creation of a single, stronger Deposit Insurance Fund through a merger of BIF and SAIF. The fund would continue to grow through a combination of earnings and risk-based premiums. The highest rated institutions would not be assessed as long as the fund remained above the statutory minimum of 1.25 percent of insured deposits. Once the fund reaches a new ceiling that would be set by Congress (after close consultation with the FDIC), the FDIC would provide risk-based rebates of any excess funds. The FDIC would have the discretion to adjust this ceiling under strict standards and procedures.

If the fund fell below the statutory 1.25 percent reserve ratio, the FDIC should be allowed to spread the recapitalization over a reasonable period. (Current law requires the FDIC to impose a 23 basis point premium to make up a shortfall that it expects will persist for a year.) This would allow the FDIC to balance the goals of replenishing the fund and maintaining a healthy banking system.

To maintain the integrity of the deposit insurance fund, institutions that grow at rates significantly above the industry average should pay a special premium on their excess growth. This should not apply to relatively small, *de novo* banks or to institutions that acquire existing insured deposits. It would not discourage regular competitive growth by established institutions or the formation of new competitors. However, it would deal with institutions that dilute the deposit insurance fund's reserve ratio by precipitately moving large amounts of funds under their effective control from uninsured to insured status.

ACB also recommends indexing the coverage levels to help maintain the role of deposit insurance in the nation's financial system. Congress should use as a base the last time it adjusted coverage primarily for inflation, which was in 1974. At that time, it increased coverage to

[2] See Appendix for roster.

$40,000. If adjusted for inflation since that time, the current coverage limit would be between $115,000 and $130,000.[3]

To recognize the increasingly important role that individual retirement savings plays in the economy and in our pension system, ACB recommends that Congress substantially increase the separate deposit insurance coverage for IRA, 401(k), and similar retirement accounts.

Summary of ACB Positions

1. ACB recommends that Congress set a ceiling on the deposit insurance fund's reserve ratio, giving the FDIC the ability to adjust that ceiling using strict standards after following full notice and comment procedures.
2. Reserves in the fund that exceed the ceiling should be returned to insured institutions based on their average assessment base measured over a reasonable period and based on premiums paid in the past. Rebatable premiums would include the SAIF special assessment, but not the high-growth special assessments.
3. When the fund is above its statutory minimum level the highest rated institutions would continue to be exempt from premiums, but the FDIC should have authority to impose a small risk-based premium on other institutions. <u>ACB supports this additional authority provided the other important reforms we recommend are included in the final package.</u>
4. Institutions that pose substantial risk to the fund would have their rebates reduced or eliminated.
5. In measuring risk for rebate or premium purposes, the FDIC should rely on additional objective information and not increase its current reliance on subjective examiner judgment.
6. Institutions that grow at a rate significantly above the industry average should be required to compensate the fund by paying a special premium on excess growth. This would avoid dilution of the fund by making the fund whole with respect to any excess growth, preventing the imposition of unnecessary premium costs on other institutions.
7. The special growth premium will not apply to smaller institutions for a reasonable period after they are chartered. It would also not apply to growth through merger or acquisition.
8. If the fund falls below 1.25 percent designated reserve ratio (DRR), the FDIC should have the authority to spread the recapitalization over a reasonable period. This would be more responsible than the current law that requires the FDIC to impose a 23 basis point annual premium if the fund is expected to remain below 1.25 percent for a year.
9. ACB strongly supports the current FDIC role as a provider of deposit insurance and strongly opposes proposals to privatize deposit insurance coverage.
10. ACB supports indexing coverage levels to maintain purchasing power. Congress should index coverage levels starting with the 1974 limit of $40,000. That would result in a coverage level of between $115,000 and $130,000 in today's dollars.

---

[3] Raising the Deposit-Insurance Limit: A Bad Idea Whose Time Has Come? James B. Thomson; Federal Reserve Bank of Cleveland Research Department; April 15, 2000 ($115,000 in 1999 dollars); FDIC Options Paper, p. 45 ($130,000 in today's dollars).

11. So long as the fund is above its statutory minimum of 1.25 percent of insured deposits, this modest increase in coverage should not require any more than a very minimal risk-based premium. If unacceptable premium increases are a condition for an immediate increase in coverage, Congress should at least index coverage from the current $100,000 level.
12. Congress should also provide substantial increases in coverage levels for retirement savings in conjunction with its work on social security or pension reform or as part of deposit insurance reform, provided this can be accomplished without an unacceptable premium increase.

Our complete comments are organized below in accordance with the FDIC Options Paper.

Pricing Deposit Insurance

Should all banks pay some premium?

The Options Paper states that, "If deposit insurance were priced according to risk, it is likely that every bank…would pay something for deposit insurance."[4] This statement fails to take into account the fact that most insured institutions paid substantial premiums in the 1990s to capitalize the FDIC funds. Both BIF- and SAIF-insured institutions paid approximately 24 basis points annually for several years, and SAIF-insured institutions made an additional one-time, 66 basis point payment in 1996. Since those institutions have never caused insurance losses, ACB believes that they have already made advance payment to compensate the fund for risk that they pose.

Nevertheless, there may be some benefit to imposing risk-based premiums on a wider range of institutions than is now permitted. Under current law, the FDIC may not charge premiums if the fund is above the 1.25 percent reserve ratio, except on "institutions that exhibit financial, operational, or compliance weaknesses ranging from moderately severe to unsatisfactory, or are not well capitalized…."[5] ACB believes that giving the FDIC the authority to impose a very modest risk-based premium even when the fund is above the statutory minimum could discourage riskier behavior and pave the way for other reforms. Such a premium should not extend to the highest rated institutions. Not only have they already paid substantial premiums, they – by definition – impose an extremely slight risk to the fund.

This broadened premium authority should not, however, be granted in isolation. ACB believes that a more reasonable recapitalization procedure, rebate authority, an excess-growth premium, indexed coverage levels, and greater coverage for retirement accounts are essential elements of a balanced plan.

[4] FDIC Options Paper, p. 3.
[5] 12 U.S.C. 1817(7)(b)(2)(A)(v).

Should there be a premium on excessive growth?

A special premium on excessive growth is essential to help prevent the fund from falling below 1.25 percent. As long as the fund remains above 1.25 percent, insured institutions can add an unlimited amount of insured deposits to the system without paying any premiums. This may lower the reserve ratio even if the absolute amount of money in the fund stays the same or if it grows modestly through earnings. It could even trigger an across-the-board premium if the fund were to fall below the 1.25 minimum. Therefore, ACB believes Congress should require the FDIC to assess growth-related premiums on institutions that grow at a rate significantly over the industry average. A growth-related premium would do two things. First, it would help the fund maintain its capitalization so that these institutions would not be "free riders" on premiums paid by long-standing members. Second, it would recognize that unusual growth is an important risk factor.

ACB believes this is an issue of great urgency. Therefore, we urge the FDIC to announce quickly that it will recommend that any premium be imposed as of the date it recommends that Congress impose such a premium. This procedure would be consistent with actions by Congress that have made new rules effective as of the date of a bill's introduction or the date of the first formal committee action.

Assessing a special premium only on significant growth would allow premium-free growth by an institution that had developed a particularly successful business plan. But, it would address the case of, for example, a diversified financial firm that was simply transferring significant amounts of uninsured funds under its effective control into its insured bank.

ACB believes that the special premium should compensate the fund at the then-current reserve ratio to avoid dilution of the fund. The FDIC should have the flexibility to collect this premium over a reasonable period to avoid imposing an undue shock on the affected institutions. While the premium might be collected over time, it should be booked immediately as a receivable in the fund to maintain its coverage ratio.

Ironically, Congress preserved the FDIC's ability to impose special assessments on *de novo* institutions.[6] Congress recognized that these institutions can be expected to grow at rates that exceed the industry average and impose other risks. However, because of their relatively small size, they cannot be expected to dilute a multi-billion dollar deposit insurance fund. The same thing cannot be said about an existing institution – now effectively exempt from premiums – that embarks on a new business plan that could add tens of billions to the insured deposit base. So, while the law correctly recognizes the risk that a *de novo* institution may impose, it forces the FDIC to ignore the risk posed by an existing institution that begins growing at a rate significantly above the industry average.

Since the FDIC already has authority to impose a risk-based premium on *de novo* institutions, it is not necessary to impose special growth premiums on them. As indicated, they add little in

[6] 12 U.S.C. 1815(d)(1)(A).

absolute dollar terms to the insured deposit base, even if their rate of growth is very rapid. In addition, public policy should encourage the establishment of *de novo* institutions to increase credit availability to all segments of the economy. Finally, when the FDIC imposes a risk-based premium on these institutions where their level of growth or other factors impose significant risk, they already provide income to the fund.

As indicated above, the special excess growth premium should not apply to institutions that grow by acquiring existing deposits from other insured institutions. By definition, these deposits are already included in the insured deposit base, so shifting them from one institution to another does not dilute the fund.

Should the recapitalization schedule be modified?

ACB strongly supports changing the assessment system to address the case where the fund falls below 1.25 percent. The current system requires the FDIC to re-impose a minimum 23-basis-point premium if a fund falls below 1.25 percent and is expected to remain there for a year or more. As the Options Paper notes, the current system "amounts essentially to charging nothing in times of prosperity, and a lot in times of adversity, thereby potentially magnifying swings in the banking cycle."[7] Congress should correct this by giving the FDIC authority to spread any recapitalization over a reasonable period. The FDIC should impose these premiums on a risk-based basis.

The system we have outlined above introduces substantial risk-based incentives, while avoiding imposing premiums on the highest rated institutions when they are not needed. However, institutions would know that they could face premiums if the fund falls below 1.25 percent and could be rewarded with risk-based rebates once the fund exceeds the new ceiling. In between, institutions that impose some risk would pay modest premiums, while those that undermine the health of the fund by growing at extraordinary rates would pay a special premium.

Should the FDIC change the way it measures risk?

The Options Paper asks whether the FDIC should "rely on supervisory judgment, … other information," or "hybrid approaches."[8] ACB believes that the FDIC should base its judgments of risk on currently available, objective information. It should not increase its reliance on supervisory evaluations. ACB believes that the current CAMELS rating system already includes a sufficient amount of examiner judgment. The FDIC currently gathers a substantial amount of objective information via Call Reports. This information is far more consistent across the range of institutions than examiner judgments. While we recognize that there is no complete substitute for direct observation by trained examiners, no amount of training can completely eliminate inconsistencies from one examiner team to the next. If call report data is not adequate, then the reporting requirement should be refined – unneeded reporting removed, worthwhile additional requirements added.

---

[7] FDIC Options Paper, p. 5.
[8] FDIC Options Paper, p. 11.

Should deposit insurance be priced from the bottom up or the top down?

In its options paper, the FDIC states "a 'bottom-up' view would set pricing at the individual bank level and let overall revenue result from the sum of payments across banks. A 'top-down' view would instead attempt to estimate appropriate aggregate funding needs and then allocate prices across banks based on risk."[9] ACB recommends against adopting either approach exclusively.

A bottom-up approach with no cap could lead to an ever-growing fund that would withdraw too much funding from the private market. Such a fund could also tempt policy makers to divert excess funding to non-insurance purposes.

Elsewhere in this letter, we recommend that Congress set a ceiling on the fund (while giving the FDIC some flexibility to adjust it under strict standards after following notice and comment procedures). To reach that ceiling the FDIC should rely on earnings and risk-based premiums. Though it would set a ceiling, a pure top-down approach also has drawbacks. It would limit the FDIC's ability to impose assessments and provide rebates in amounts that differ according to the relative risks posed by individual institutions.

Thus, we recommend a combination of the two approaches. From the top-down approach, we recommend imposing a cap on the fund (which the FDIC could adjust). From the bottom-up approach, we recommend a combination of risk-based premiums (where appropriate and needed), excess growth premiums, and risk-based rebates.

Should the FDIC use peer comparisons or absolute ratios?

ACB believes there is some value in measuring an institution's risk by comparing it with other, similar institutions. Comparisons would be useful in relatively good and stable times and outliers would tend to stand out. However, in times of general economic difficulty a peer comparison approach could be misleading. If most institutions were doing equally poorly and presenting serious risk, a pure peer analysis would fail to set off alarm bells. We also note that as each institution pursues increasingly diversified strategies, it is becoming harder to find true peers. As in the debate over bottom-up versus top-down premium structures, the answer has to be a careful combination of the two approaches.

Should the FDIC use market information to determine premiums?

The Gramm-Leach-Bliley Act requires a test of whether market mechanisms might help regulators measure and reduce risk among the largest institutions. Section 108 of the GLB Act directs the Federal Reserve and the Treasury to study the implications of requiring large insured depository institutions and depository institution holding companies to maintain a portion of their capital in the form of subordinated debt.[10]

---

[9] FDIC Options Paper, p. 11.
[10] Public Law 106-102, Nov. 12, 1999.

This approach may be useful in comparisons among large institutions that pose a systemic risk and which may benefit from perceived too-big-to-fail protection unavailable to community banks. Nevertheless, ACB opposes using similar market-related tests for deposit insurance pricing. We share the concerns expressed in the Options Paper. First, the markets would likely take the too-big-to-fail implicit guarantee into account, giving higher ratings to larger institutions.

Second, the FDIC has more information about all banks than anyone in the private market. Unless the examination process is poorly conceived and implemented, it surely generates insights that are not available to the market. Market signals may be used to confirm or redirect examination resources, though any banking concern big enough to be the object of intense market scrutiny probably has a permanent examiner on site anyway.

Third, market pricing is a combination of a judgment about the particular institution involved and general conditions. During some periods institutions may not be able to issue debt at all. Finally, ACB does not believe that it is appropriate for the FDIC to rely on private firms' judgment when making an important public policy decision, e.g., the amount of premium to charge for federal deposit insurance and the level of rebates to provide.

Smaller institutions would be particularly disadvantaged by increased reliance on market judgment to assess premiums. It is rarely efficient for smaller institutions to issue debt of any type, and what may be issued is thinly traded. While the law permits the FDIC to establish separate pricing mechanisms for large banks,[11] we believe that widespread use of that authority is unnecessary and potentially divisive. ACB is concerned that such a system may discriminate against smaller institutions in certain geographic markets and those with concentrations in particular assets, e.g., home mortgage loans.

Should the FDIC enter into private reinsurance contracts to obtain market judgment about risk?

ACB understands that the FDIC has begun the process of studying this question with a private-sector firm. The issue is whether the FDIC could draw on information from the reinsurance markets for deposit insurance pricing. ACB believes the FDIC should look carefully to determine whether the private reinsurance market has the capacity to reinsure any substantial portion of depository institutions. It should also examine whether private reinsurance activities might impose an unwarranted insurance premium differential between large and small institutions. Finally, private reinsurance firms might seek access to examination data generally not made available to private parties.

While not included as possibility in its Options Paper, ACB wishes to reiterate at this point that we strongly oppose proposals by others to privatize deposit insurance. The nation's economy has depended for decades on the FDIC and the ultimate backstop of the Federal Government. The

[11] 12 U.S.C. 1817(b)(1)(D).

private insurance market would be unable to engender the kind of public confidence made possible by the FDIC.

Structure of the Deposit Insurance Fund

Should deposit insurance be based on a User-Fee or Mutual model?

The Options Paper raises the question of whether the deposit insurance system should be reconfigured on a user-fee or mutual model. ACB believes it would not be useful to adopt a pure version of either. The terms themselves conjure up specific approaches from the past that may be misleading models for the future and could confuse more than clarify the debate. Instead, policy makers should decide the specific characteristics that they want today's system to have. It may be that the final product will look more like one than the other. We expect that it will have many elements more characteristic of a mutual arrangement. That is certainly how it has worked in the past. Congress has asked insured depository institutions to pay whatever it would take to pay the costs of running the system. And, for much of the history of the system, from 1950 until the 1980s, the law provided for rebates to insured institutions. Those certainly are characteristics of a mutual model.

Of course, when it became impossible for institutions insured by the Federal Savings and Loan Insurance Corporation to cover the losses of its fund, the government did step in. And, the Treasury advanced funding to the BIF when that became necessary. These actions were characteristic of the user-fee model. Even here, however, SAIF- and BIF- insured institutions had to pay substantial premiums to recapitalize their funds. In addition, Congress insisted that insured institutions – first SAIF-insured institutions and then all FDIC-insured institutions – pay the interest on Financing Corporation (FICO) bonds that were issued to pay depositors. This "mutual" feature will be with us for years to come.

It is very clear that under the current statutory scheme, insured institutions are members of an assessable mutual system, with only a reimbursable financing line of credit from the Treasury. The only effective constraint on assessments is when they are causing more new failures than they are paying to resolve.

Former FDIC Chairman Ricki Helfer recently answered the question of mutual versus user-fee model this way:

> *Those kinds of categorizations can be useful for analytical purposes perhaps, but sometimes they can also obscure rather than clarify the relevant issues. Neither categorization best represents the way the system operates now nor the way that it can best serve American depositors in the future. The short answer to the FDIC's questions is that there are elements of both in a system that has risk based deposit insurance and permits rebates from an over-capitalized fund. Buried in the terminology is the real issue: is there a maximum reserve ratio for each deposit insurance fund that can be identified at any particular time based on then existing circumstances? If there is, should banks enjoy rebates of reserves above that level, and can we design a rebate system that meets our second goal by maintaining a risk-based deposit insurance system and still provide rebates to banks from reserves above the ceiling?*[12]

The approach we suggest – pick the characteristics of the fund first and avoid artificial labels – also enables policy makers to avoid awkward proposals that would unnecessarily complicate their decision-making. For example, a pure mutual model might resemble the National Credit Union Share Insurance Fund (NCUSIF). Under that system, institutions maintain deposits in the fund and simultaneously carry them as assets on their books.[13] The General Accounting Office criticized this accounting treatment in 1991 and suggested that credit unions write off these assets over time.[14] Since credit unions are not publicly traded, this accounting issue is not heavily debated and does not affect investors. In contrast, stockholder-owned banks and savings institutions must be responsive to investor concerns. As a result, a pure mutual-model similar to NCUSIF might have to include a number of artificial constructs to conform to accounting rules. There does not seem to be any substantial public policy benefit to the exercise.

Many of the policies we recommend elsewhere in this comment – a cap on the fund, rebates, increased risk-based premium authority, and excess-growth premiums – tend to reinforce the mutual aspects of the system. But, we recommend them because we believe they will strengthen and improve the system, not to add new mutual features.

Should a rebate system be reinstated?

As indicated elsewhere in this comment, ACB strongly believes that Congress should set a ceiling on the fund and rebate excess payments on a risk-based basis. During the 106th Congress, ACB supported legislation introduced by Senator Rick Santorum (R-Penn.) and Representative Frank Lucas (R-Okla.) that would have set a 1.35 percent ceiling and used the excess to pay interest on FICO bonds.[15] Once the FICO bonds were repaid, excess funds would be used to pay rebates. The bill would have given the FDIC authority to change the ceiling.

---

[12] The Deposit Insurance System: What Reforms Make Sense?; Ricki Helfer, December 4, 2000; Address to America's Community Bankers, pp. 8-9 (Helfer, Dec. 4, 2000)
[13] FDIC Options Paper, p. 31.
[14] Credit Unions – Reforms for Ensuring Future Soundness; GAO/GGD-91-85, July 1991, pp. 171-174
[15] S. 2293 and H.R. 3278.

ACB continues to believe that this is a constructive approach to a serious potential problem that could be caused by a substantially overcapitalized insurance fund. However, the broader approach we outline in this letter could lead to full rebates more promptly than provided for in the Santorum/Lucas bill. Whatever the mechanism Congress provides, resources not needed for reasonably foreseeable deposit insurance purposes should not remain in Washington.

ACB agrees with former Chairman Helfer's recent comment:

> *I believe it is possible for the FDIC to develop analytical tools that will permit it to identify a ceiling on the funding needs of the deposit insurance system at any particular time – a DRR that would change as circumstances change….The purpose of establishing a ceiling DRR is so that insurance funds will not grow beyond a size that can be justified on the basis of the needs of the deposit insurance system, thereby withdrawing capital from banks who could have contributed to economic growth by leveraging those funds to meet the economic needs of their communities. Amounts accumulated in the system over and above the DRR ceiling should be rebated to banks to facilitate economic activity, which benefits every one.*[16]

What levels should the Fund reach before the FDIC pays rebates?

ACB believes that Congress should adopt the approach taken in the Santorum/Lucas legislation and determine an appropriate ceiling for the fund. In deciding the actual ceiling amount, ACB recommends that Congress consult closely with the FDIC. The agency has already done considerable historical analysis on the level of the funds and income needed to maintain them.[17] Clearly, the agency could adapt that analysis to determining a reasonable ceiling to recommend to Congress. As provided in the Santorum/Lucas bill, Congress should give the FDIC flexibility to adjust the ceiling. However, the agency should have to meet clearly stated standards before adopting a change. The FDIC should be required to find that there is a higher level needed to meet a substantial and identifiable risk to the fund or the financial system.

In addition, Congress should require the FDIC to follow a full notice and comment process under the Administrative Procedure Act before making any change to the ceiling. Any delay associated with this process should not cause undue concern, since the FDIC would, in all likelihood, be making a change when the fund was near its ceiling, substantially above the 1.25 percent minimum.

How should rebates be allocated?

The Santorum/Lucas legislation would provide rebates to all insured institutions once the FICO obligation is met. Until that time, excess funds in BIF and SAIF, or a new DIF, would be used to offset all insured institutions' FICO obligation or would remain in the fund. ACB continues to believe that this approach has merit and would support the Santorum/Lucas bill as a stand-alone proposal. However, we also believe that there is considerable merit to providing for a risk-based rebate system that could provide rebates before the FICO obligation ends. Under the system we

[16] Helfer, Dec. 4, 2000, pp. 9-10
[17] 60 Fed. Reg. 42680 (Aug. 16, 1995).

favor, the riskiest institutions would get no rebates, while the safest institutions would get higher than average rebates. Those in between could expect average rebates. These differential rebates would provide the same risk-reduction incentive as variations in premiums when the fund needs them to impose them on the bulk of insured institutions. All institutions would know that as the fund approached the ceiling, they could expect to benefit by operating in a less risky manner.

Should the Systemic Risk/Too-Big-to-Fail mechanism be changed?

In FDICIA, Congress substantially limited the FDIC's ability to provide unlimited protection to depositors in too-big-to-fail institutions. The FDIC may not protect uninsured depositors and creditors if that would increase costs above simply covering insured deposits. As the Options Paper notes, this least-cost test can be overcome only if "the Secretary of the Treasury, upon the recommendation of two-thirds of the Boards of the FDIC and the Federal Reserve, and after consultation with the President, determines that a threatened bank failure would pose serious adverse effects on economic conditions or financial stability, the least-cost requirements can be avoided….[18] This procedure has never been implemented, but it certainly appears to impose substantial procedural hurdles to further FDIC involvement in the too-big-to-fail process.

Nevertheless, it is still possible that at some point the FDIC will step in under the systemic-risk exception to the least-cost requirement. The law requires that the FDIC impose a special assessment on all fund members to defray the excess cost of a systemic-risk resolution. Unlike normal assessments, this special assessment is based on total assets (minus equity capital and subordinated debt). When adopted in 1991, it was thought that this would tend to shift costs to larger banks that relied less on deposits to fund their assets. This did not exempt banks that could never expect to benefit from a systemic-risk rescue, but it was hoped that it would rebalance the scales to some extent.

This analysis is becoming dated because community banks themselves rely more on funding from the Federal Home Loan Banks as the competition for deposits becomes more severe. The balance sheets of large and small banks – in terms of their reliance on deposits as compared to borrowed funds – are likely to become more similar over time. Therefore, Congress may wish to consider doing directly what they attempted to do indirectly in 1991 and exempt banks under a certain size from any systemic-risk special assessment.

Though the FDIC's role in the too-big-to-fail process may be reduced, the Federal government, particularly the Federal Reserve, continues to have a major role in dealing with financial crises. Under the new financial structure provided under the Gramm-Leach-Bliley Act, this implicit shift of much of the too-big-to-fail responsibility from the FDIC to the Federal Reserve has merit. The fact remains, that invoking this protection for larger financial firms provides benefits to a just a few firms. Policy makers should continue to explore ways to impose some cost for this benefit, recognizing it is difficult to explicitly price an implicit benefit.

[18] FDIC Options Paper, p. 33.

Coverage Levels

Should Congress increase general coverage limits?

ACB supports indexing coverage to maintain purchasing power. We also strongly support substantially increasing coverage for retirement savings, such as IRA and 401(k) accounts. In either case, we support increases provided they are not accompanied by substantial additional premiums. Most ACB members are skeptical that increases in general deposit insurance coverage levels would significantly increase funding. Former FDIC Chairman Helfer is even more skeptical. She recently said that "there is very little evidence that doubling the coverage limits will expand the deposit base of smaller banks. Community bankers that I have talked to think that very little benefit will result from a significant increase in coverage limits."[19]

However, it could improve community bank funding in some markets. In addition, increased coverage can be a helpful accommodation to some customers who wish to deposit relatively large, one-time receipts from, for example, the sale of a home or an inheritance. This would be valuable to a consumer who values safety, but is unlikely to fuel substantial sustained deposit growth throughout the banking system. Residual concerns that excess growth could result can be dealt with by ensuring that rapidly growing institutions pay a deposit insurance premium that reflects the greater risk they pose to the system and maintains the capitalization level of the fund.

Most ACB members believe that they can more effectively increase funding by offering increased interest rates, not through increased deposit insurance coverage. However, they recognize that these deposits are not as "loyal" as core deposits. Similarly, ACB members are concerned that increasing coverage levels could increase the size of very large deposits, complicating banks' liquidity management. Large deposits attracted simply by relatively high rates of interest often leave just as quickly as they are attracted. This could be the case with larger deposits attracted by increased deposit insurance coverage.

Though ACB recommends that a premium be imposed on institutions that experience unusually high growth, we do not believe that even doubling nominal insurance coverage would justify a substantial premium increase on all institutions. Even if coverage is increased to $200,000, the average account balance is certain to remain very substantially below that level. Small depositors with say, $1500, in checking and savings accounts are not going to increase their total deposits just because the upper insurance limit is increased. And, competitive factors suggest that substantially increased nominal coverage will not increase the overall deposit base by a large amount. Depositors with large sums may shift insured deposits from one bank to another to consolidate balances or take advantage of higher interest rates. But, one bank's gain may well be another bank's loss. ACB members who responded to our survey estimated only a net gain of 3 percent as a result of increasing insurance coverage to $200,000. Thus, doubling coverage levels is not the same as doubling the FDIC's risk.

[19] Helfer, Dec. 4, 2000, p. 12

Should coverage limits be indexed?

If a substantial increase in coverage is not feasible, ACB supports indexing of the $100,000 level to maintain its purchasing power. This would not completely address the loss of coverage to inflation experienced since coverage was increased to $40,000 in 1974 and $100,000 in 1980. If coverage had been indexed using 1974/$40,000 as a base, the current level would be between $115,000 and $130,000; if indexed using 1980/$100,000 as a base, the current level would be approximately $200,000. Clearly, an adjustment accounting for inflation since 1974 is reasonable but such an increase would not justify an unacceptable premium increase. Former FDIC Chairman Helfer believes this is a "better approach" than increasing coverage to $200,000. However, she indicated that, "Whatever the correct number, it is the principle of indexing that is important."[20]

Indexing on a going-forward basis would certainly not justify any premium increase and would have the clear advantage that the FDIC identified in its Options Paper – insulation from political cross currents and maintaining "the same relative importance of deposit insurance in the economy over time…."[21] Indexing using the current level also avoids the debate over what year and level should be the basis for indexing. For better or worse, depository institutions and the economy have adjusted to the current level of coverage. Indexing would maintain that balance rather than seeking to recalibrate it based on a level that had been appropriate in the past.

To simplify and reduce the cost of implementation, as well as to promote consumer understanding, we recommend that any increases be provided only in $10,000 increments. Some ACB members are especially concerned that frequent small adjustments would be more costly than any benefit they might realize from increased deposit funding.

Should coverage for retirement accounts be increased?

Congress has provided substantial tax incentives to encourage individuals to accumulate retirement savings. These individual savings are replacing resources that employers previously provided through defined benefit pension plans. This shift in retirement funding has increased the burden on individuals to manage their own assets. As individuals respond to tax incentives, their retirement assets often exceed the current $100,000 coverage limit by substantial amounts. Since planners generally recommend that individuals shift these savings into more secure and stable investments as they approach retirement, ACB believes that Congress should substantially increase deposit insurance for retirement savings that meet the tax requirements established under the Internal Revenue Code. Congress could provide increased coverage as part of deposit insurance reform, or in conjunction with enhancements to retirement savings incentives or social security reform.

---

[20] FDIC Options Paper, p. 14
[21] FDIC Options Paper, p. 44.

Should coverage for municipal deposits be increased?

ACB members hold differing views on increased coverage for municipal deposits. This generally reflects differences in state and local practices. For example, in Minnesota local governments have joined together to form mutual funds for their liquidity needs, effectively bypassing insured depository institutions. New Jersey has a centralized and relatively straightforward system for collateralizing public deposits that makes it unnecessary for banks to match specific collateral with specific deposits. In other states banks are still able to compete for these deposits, but must follow complicated collateralization requirements. Bankers in those states believe they would benefit from increased deposit insurance for municipal deposits. Similarly, minority institutions also believe would benefit from increased deposit insurance for these deposits. However, policy makers must avoid imposing an across-the-board premium for increased coverage that would not benefit all institutions.

Should the FDIC make excess or co-insurance available as an option?

ACB does not support optional deposit insurance or co-insurance for amounts over the general coverage limit (whether the current $100,000 limit or some higher amount). ACB members believe that this could lead to confusion among depositors, with some banks offering more FDIC insurance than others. It would add an unnecessary complication to a system that the public understands fairly well, at least in broad outline. Other ACB members have commented that competitive pressure would eventually result in all institutions offering "optional" coverage. Finally, institutions that wish to provide additional protection for special cases can collateralize individual deposits or seek privately funded overline insurance. While private insurance could never substitute for basic FDIC coverage – no conceivable private firm could have the capacity – carefully targeted overline insurance is feasible and currently available.

Should the rules for determining coverage be further simplified?

In recent years, the FDIC has taken careful steps to simplify rules for coverage. ACB generally supported these changes, but we do not support further substantial changes in coverage rules. The Options Paper suggests that, "The most straightforward option would be to…eliminate the separate insurance coverage that is currently provided for accounts held in separate rights and capacities…."[22] (Note our view expressed above about the separate coverage of retirement accounts.) Any changes might simplify coverage computations, but would also tend to reduce the amount of coverage available. This would make it more difficult for institutions to attract deposits. In addition, further changes could actually complicate the work of new-accounts representatives in community banks. Too-frequent rounds of "simplification" would be costly to implement and provide too many opportunities for mistakes and misunderstandings.

[22] FDIC Options Paper, p. 46.

Conclusion

ACB appreciates the opportunity to comment on this important matter. We believe that it could lead to substantial improvements in the deposit insurance system.

These are ACB's key recommendations:

- BIF and SAIF should be merged without delay;
- Congress should set a ceiling on the merged fund and provide for rebates;
- If other important reforms are provided, the FDIC should have expanded authority to impose modest risk-based premiums;
- Highly rated institutions should continue to be exempt from premiums so long as the fund is above its statutory minimum level;
- If the fund falls below that level, the FDIC should have the flexibility to recapitalize it over a reasonable period;
- Institutions that grow at excessive rates should pay a special premium to maintain the integrity of the fund;
- The FDIC's current role should be maintained; deposit insurance must not be privatized;
- Congress should provide increased coverage by indexing coverage from the 1974 level of $40,000, without imposing significant additional premiums;
- Congress should substantially increase coverage levels for retirement savings.

If you have any questions, please contact Steve Verdier at (202) 857-3132.

Sincerely,

Diane M Casey

Diane M. Casey
President and CEO